No. 2580

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

J. W. RAPPLE,

Appellant,

vs.

HARRY A. DUTTON, as Trustee of the Estate of LENNIG ENGINEERING CO., Bankrupt,

Appellee.

APPELLANT'S PETITION FOR A REHEARING.

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To the Honorable William B. Gilbert, Presiding Judge and the Associate Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Appellant Rapple respectfully asks that the decision of the court herein be set aside, and a rehearing be granted.

This is a proceeding in bankruptcy seeking the application of an asset of the partnership of Lennig and Rapple to the payment of a firm creditor. This court has decided (1) that equity will so distribute

the asset in the custody of the bankruptcy court only if the firm was insolvent at dissolution; and (2) that the law in California although in favor of Rapple's contention, does not establish a rule of property binding upon the federal court. Appellant respectfully submits that the reasoning upon which both of these conclusions rest deserves reconsideration.

1. The firm asset is in the custody of the court and should be applied to pay the firm debt; the case of Filmar so decides and this court's statement that the partnership of Filmar and Swigert was insolvent at the time of dissolution is opposed to the facts of that case.

The weight of authority is undoubtedly (as this court holds), that a retiring partner's lien is lost upon a dissolution such as the one at bar. But the first of our contentions was and is that if the firm asset is placed *in custodia legis* before it passes into the hands of a *bona fide* purchaser, a court of equity at the instance of the retired partner, will give the firm creditor priority. We cited *In re Filmar,* 177 Fed. 170, as a case directly in point. The opinion of this court states that the distinctive feature of the *Filmar* case was the insolvency of the partnership at dissolution. We believe, on the other hand, that it was the fact that the firm asset was in the custody of the court. We ask this court's indulgence while this decisive question is considered.

The language of this court is as follows:

> The opinion (in the *Filmar* case) recites that the partnership assets were then in excess of the partnership debts, but notwithstanding that fact it may be assumed that the partnership was found to be insolvent, for within six weeks after the dissolution Filmar filed his voluntary petition in bankruptcy.

This statement is the gist of the decision here. With due respect, we believe that a moment's consideration will suffice to demonstrate that it is open to serious question.

If at dissolution the assets of the partnership of Swigert and Filmar "were in excess of its debts", is not that conclusive of the solvency of the firm? Is it not self-contradiction to say that such a firm is insolvent?

The meaning of insolvency is given in Words and Phrases:

> Insolvency, in its general sense, is a term used to denote an insufficiency of the entire property and assets of an individual to pay his debts. (citing cases.)

The Bankruptcy Act of 1898 defines insolvency:

> A person shall be deemed insolvent within the provisions of this act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed, or removed, with intent to defraud, hinder or delay his creditors, shall not, at a fair valuation be sufficient in amount to pay his debts. (Sec. 1.)

Plainly, then, excess of assets over debts precludes the idea of insolvency. Moreover, a partnership is not insolvent unless the assets of the firm, *together with those of the partners as individuals,* are collectively insufficient to pay the firm debts. This was decided by the Circuit Court of Appeals for the Sixth Circuit in *Vaccaro v. Security Bank,* 103 Fed. 436, where Justice Lurton after stating this rule concluded:

> The decided and clear weight of the evidence is that the aggregate of the property of the firm and of the individual estates of A. Vaccaro, B. Vaccaro, and A. B. Vaccaro, who composed the partnership, after deducting exemptions, dower of the widow of A. Vaccaro, and making provisions for the individual debts of each, was, at "a fair valuation, sufficient in amount to pay all of the debts of the partnership". A. Vaccaro & Co. were, therefore, not insolvent on August 23 or 24, 1900, within the definition of the bankrupt act. (p. 444.)

Thus Swigert's personal assets were to be considered as well in determining the financial status of the partnership at dissolution. His sound condition is demonstrated by the fact alone that Swigert instituted the proceeding to save himself from the necessity of paying the partnership debt. We, therefore, respectfully submit that the firm of Swigert and Filmar was not insolvent at dissolution.

Let us go further and consider the reason assigned by this court for its conclusion. It is said that "within six weeks after dissolution Filmar filed his voluntary petition in bankruptcy". Appellee here, in an endeavor to distinguish the *Filmar* case,

was content to suggest that this incident led to the conclusion that the continuing partner was insolvent. In response to this we pointed out (and it is equally pertinent to the reasoning of the court's opinion) that in six weeks of Filmar's sole incumbency in the business, its affairs may have undergone and no doubt did undergo a complete change. Through poor business judgment and, perhaps, use of the funds in his personal affairs, Filmar may have dissipated the assets. (Reply Brief, p. 5.)

The assumption of insolvency of the firm resting upon the fact of Filmar's subsequent bankruptcy is, we respectfully submit, unwarranted. It is an *assumption* in direct conflict with the *facts* stated as the basis of the decision.

It is also noteworthy that from the fact that "Filmar filed his voluntary petition in bankruptcy" it does not necessarily follow that he was insolvent. A solvent debtor may employ the medium of the bankruptcy court to have his assets distributed among his creditors (*Collier on Bankruptcy,* 8th Ed., p. 96). Is it likely, however, that Filmar was insolvent. But it is conceivable (as we said in the reply brief) "that the decision was based upon a fact which is not stated in its opinion"? Should we not, rather, look to the reasons given by the court as the basis of its conclusion? These are: that the property was in the custody of the court and there has been no application of it to the payment of individual debts. *Sargent v. Blake,* 160

Fed. 57, is then cited—a case where the partnership was insolvent at dissolution but the firm creditors were denied relief *because the assets had been transferred to a bona fide purchaser prior to an occasion for their administration in a court of equity.*

In our reply brief (page 6) we pointed out that in the first paragraph of Judge Sanborn's syllabus in *Sargent v. Blake* it is stated that both the partnership and its members were insolvent. Notwithstanding this, the endeavor to recover the firm asset in a plenary proceeding from one who had taken it for value failed. Yet this court immedately after quotation from the *Sargent* case draws this distinction:

> A different rule applies where the transfer is by one of two partners to the other of his interest in an *insolvent* partnership.

The court then proceeds to discuss the *Filmar* case. Is it not clear that *Sargent v. Blake* is a case of an insolvent partnership and the *re Filmar* is not? It is respectfully submitted that the decision of this court is opposed to the conclusion reached in an identical case (*Filmar*) by the Court of Appeals for the Seventh Circuit and that the basic principle upon which the decision here rests is directly in conflict with the law as laid down by the Court of Appeals for the Eighth Circuit (*Sargent v. Blake*) in consonance with the decisions of the United States Supreme Court—*Case v. Beauregard; Fitzpatrick v. Flannagan.*

These authorities establish that the essential to the preference of the firm creditor at the instance of the retired partner is that the asset is *in custodia legis* and not, as this court has held, that the firm was insolvent at dissolution. Whether insolvency would produce the result for which we contend is not of vital importance here; it is sufficient for the purposes of this case that before the firm asset was transferred to a *bona fide* purchaser, it came into the bankruptcy court and is here subject to equity's rule of distribution at the instance of the retired partner.

2. Conroy v. Woods establishes a lien—a property right—of the retired partner in the firm asset after dissolution; this is a rule of property and the title of the trustee is subject to Rapple's lien.

The court has declined to apply the rule announced in *Conroy v. Woods*, 13 Cal. 626, upon the ground that it "involves no construction of a state statute, nor does it establish a rule of property, but it decides a principle of equity only, and it is not binding on a federal court". Here the court has failed to notice that the status of partnership assets is now in California a matter of statutory provision. By Sec. 2405 of the Civil Code (opening brief, page 4), a lien in favor of the partner is created in firm assets to have them applied to the discharge of the firm debts. The statute does not limit the existence of the lien to the period during

which the partnership continues as a going concern. A partnership does continue, in contemplation of law, nowithstanding dissolution, until its debts are paid. This court so held, as we pointed out at page 7 of the opening brief, in *Holmes v. Baker & Hamilton,* 160 Fed. 922.

The *Conroy* case (decided before the statute was enacted) held that the partner's lien persisted after dissolution where (as here) the continuing member assumed the debts. All the authorities concede the existence of that lien before dissolution. This is a property right. And in this state it survives the dissolution. Therefore, the asset involved in this case was prior to the bankruptcy impressed with a lien in favor of Rapple. Did the bankruptcy destroy it? It is settled law that the trustee takes the assets as the bankrupt held them, subject to all claims, liens and equities. Authorities to this effect and holding further that the validity of such liens "*is to be determined in the absence of federal statutes by the local law as evidenced by the decisions of the state courts*" were cited in the opening brief (pages 13-14) but have not been noticed in the opinion of this court.

It is universally held that before dissolution each partner has a lien and that the firm assets are subject to a trust in favor of the partner to ensure the payment of the firm debts. This lien or trust is equally operative under the law of California upon the fund now in court as before the dissolution. A lien is clearly a property right; if this is true of

the claim of a beneficiary upon a trust fund, Rapple's position is doubly secure. The Supreme Court has so decided in a recent case reported since the briefs herein were written—*Brown v. Fletcher*, 235 U. S. 589. There the matter of diversity of citizenship was involved. The trustee and beneficiary of a trust fund were citizens of New York. The latter assigned his right to a citizen of Pennsylvania who sued the trustee in the federal court. If this were a mere *chose in action* or a claim upon contract, jurisdiction under Sec. 24 of the Judicial Code would have failed. But the Supreme Court held that even though the trust *res* were funds in cash, the right of the beneficiary was a *property right* and on that ground sustained the federal jurisdiction.

The failure of the court to appreciate that Rapple is relying here upon a property right and not upon an equitable remedy nor a rule of equitable distribution is perhaps due to the fact that the discussion of this question was immediately preceded by a consideration of the principle of marshalling assets in the bankruptcy court as laid down in such cases as *in re Filmar.* In that case, under the rule of that jurisdiction, there was no partner's lien after dissolution and therefor no property right was involved. The contention of the retired partner was based upon "equity's rule of distribution" of the fund in court. So, with this idea in mind this court no doubt proceeded to consider Rapple's claim as of the same

character. But in this aspect of Rapple's position, he is not restricted to a prayer for an equitable distribution of the fund; he relies upon a rule of property laid down by the court of the state in which the asset is located and which has exclusive power to regulate the title to personal property within its limits. This is a radical distinction.

An examination of the authorities cited by this court in its opinion serves to confirm what we have said:

In *John Deere Plow Co. v. M'David*, 137 Fed. 802, the bankrupt had received funds belonging to the claimant and converted them in the transaction of his business, so that neither the funds nor any property substituted for them could be identified. Thus, there was no specific *res* involved upon which a trust or equity could be fastened. The claimant, therefore, sought to establish a preferred claim against the entire estate of the bankrupt. There was no right in specific property involved. The question was one of equitable preference—like in the *Filmar* case—and the decision of the state court that under such facts the claimant should have "a preference upon the entire body of the trustee's estate in insolvency upon the ground that the trust fund has enhanced the estate", was not controlling. The case is, therefore, not in point here.

In support of the following statement: "this rule is especially applicable to questions of equity law,

as to which federal and state courts appeal to the same sources of information", this court has cited *Butler v. Douglas,* 3 Fed. 612. The question there was whether a federal court of equity should adopt as the period of limitation in a suit to foreclose a vendor's lien the length of time required to bar an action at law for the purchase money, and what effect the decision of the state court should have. It was held:

> In the determination of *such a question of equity law* the federal and state courts appeal to the same sources of information, and the decisions of either are not binding on the other.

The decision is thus far afield from the case at bar. Moreover, its value as authority is extremely questionable, because the Supreme Court of the United States has reached a contrary conclusion in an analogous case—*Dupree v. Mansur,* 214 U. S. 161. It was there held:

> Where it is established law of a State, as it is of Texas, that when a debt is barred by limitations an action to foreclose a lien or mortgage given as security for it is barred also, the law must be enforced in the courts of the United States, whether sitting in law or in equity.
>
> Whether or not the statute of limitations bars a suit to foreclose is a question of substantive law, created by the State and not by the United States, and not one of procedure or jurisdiction; and the federal court should be governed by the decisions of the State where the land lies. (Syll. 1, 2).

In *Lane v. Vick,* 3 How. 464, it was held that the construction of a particular will by the state court was not conclusive upon the federal court where the decision had not become a rule of property. This is not pertinent to the facts at bar. The theory underlying such a decision is clearly explained in a later case—*Russell v. United States Trust Co.,* 127 Fed. 445:

> The federal courts adopt the local law of real property, as ascertained by the decisions of the state courts, whether grounded on the construction of statutes or the unwritten law of the state, including that pertaining to the construction of wills. But upon the question whether the expression of a testator, in his will, of a wish or recommendation, will create a trust, the decisions of the state courts merely afford a guide in applying the general rule that the intention of the testator is to be effectuated. (p. 446.)

Oates v. Bank, 100 U. S. 239, and *Railroad Co. v. National Bank,* 102 U. S. 14, both presented the question whether one who receives a promissory note as security for an existing indebtedness is a purchaser for value. This, plainly, involves no property right, but merely a matter of general commercial law and thus does not touch the instant case.

Liverpool Co. v. Phoenix Ins. Co., 129 U. S. 397, another case cited in the opinion, was a suit in admiralty where a stipulation exempting a common carrier from responsibility for the negligence of its servants was considered. The nature of the

question as well as the forum in which it was raised required the independent judgment of the federal court.

But one other case is cited by this court—*Loewe v. Federation of Labor,* 189 Fed. 714. The exercise of the equitable power of injunction was there in question. It was held that in applying such "general principles of equity" the court would determine for itself "what those principles are".

These authorities, we submit, are far afield from the issue at bar. No one of them is nearly so pertinent as the cases upon which Rapple relied in his brief. In order to present more fully to this court his plea for a reconsideration of the cause, we will look further into the decisions upon the question.

The authorities hold, without exception, that where the title to real or personal property is involved the rule of decision established by the state tribunal will govern the federal court. The decisions to be cited do not involve a construction by the state court of a local statute, but concern the law of judicial decision.

In *Dooley v. Pease,* 180 U. S. 126, the decision of the state court concerning the effect of possession of personal property was followed. It was held:

> It is equally well established that the courts of the United States regard and follow the policy of the state law in cases of this kind.

> "Any other rule," said this court in *Green v. Van Buskirk*, 7 Wall. 139, "would destroy all safety in derivative titles and deny to a State the power to regulate its personal property within its limits." (p. 128.)

This case is cited and followed in *Re Richheimer*, 221 Fed. 16 (C. C. A. 7th Circ.) where it was held:

> That ownership and transfer of and liens upon personal property which has come within the state are subject to and controlled by the policy adopted by the state for regulation and control thereof (p. 23.)

In *Re Antigo Screen Door Co.*, 123 Fed. 249 (C. C. A., 7th Circ.), in determining the rights of the parties to a fund of the trustee in bankruptcy derived from the sale of personal property, the court held that it was governed by the law concerning chattel mortgages as decided by the state Supreme Court.

Other bankruptcy cases are numerous in which rights in personal property covered by mortgage have been adjudicated. In *Dodge v. Norlin*, 133 Fed. 363 (C. C. A., 8th Circ.)—a bankruptcy proceeding—it was held:

> The decisions of the highest judicial tribunal of the state in which a chattel mortgage is made determine its validity in the national courts. (p. 379.)

In *Dugan v. Beckett*, 129 Fed. 56 (C. C. A., 5th Circ.), also a bankruptcy case, it was held:

> In determining whether a chattel mortgage executed by a bankrupt was fraudulent on its

> face, the federal courts follow the decisions of the courts of last resort of the state in which the controversy arose, the law on the subject being regarded as a rule of property. (Syllabus 1.)

The same decision is reached in *In re First National Bank,* 135 Fed. 62 (C. C. A., 6th Circ.).

The existence of an attorney's lien upon a fund was the question in *Cain v. Hockensmith Wheel Co.,* 157 Fed. 992, it was held:

> Whether an attorney has a lien for services rendered on money recovered as the result of his efforts is a matter of local law not to be disposed of on independent views entertained by the federal courts. (Syllabus 2.)

The decisions of the state court were consulted and followed.

The rights of the parties in a bankruptcy proceeding to personal property under pledge were determined by the same rule in *Security Warehousing Co. v. Hand*, 206 U. S. 415. It was held:

> There was no valid disposition of the property in the case before us, or of any valid lien. The so-called warehouse receipts issued by the warehousing company to the knitting company, upon the facts of this case, gave no lien under the law in Wisconsin, in which State they were issued. In such case this court follows the state court. (p. 425.)

Again, in a case where a contract concerning personal property was involved in *In re East End Mantel Co.,* 202 Fed. 275, the court held:

> The law of the state wherein a contract of sale or pledge is made and is to be performed must govern in the bankruptcy court in determining its validity. (Syllabus 1.)

The rights of the parties under a contract of conditional sale of personal property were adjudicated in the same way in *Bryant v. Swofford Bros.*, 214 U. S. 279. It was held:

> * * * In bankruptcy the construction and validity of such a contract must be determined by the local laws of the State. That such a contract is a conditional sale and is valid without record is the law of Arkansas (citing decisions of the state court). The trustee has no higher rights in this regard than the bankrupt. (pp. 290-1.)

In determining the effect of a contract the court held in *In re Heckathorn*, 144 Fed. 499:

> In a proceeding against a bankrupt's trustee to recover certain goods alleged to have been bailed and not sold to the bankrupt, whether the contract constituted a bailment or a sale is governed by the local law. (Syllabus 1.)

The rule is, of course, equally well settled in the case of vendor's liens. In *Slide Gold Mines v. Seymour*, 153 U. S. 509, the rule of decision in Colorado recognizing the vendor's lien—the creature of equity—was held to govern the federal court (pp. 516-17).

In *Consolidated Smelting Co. v. Hinchman*, 212 Fed. 813 (C. C. A. 1st Circ.), the rule that the trustee in bankruptcy takes property subject to the

equities impressed upon it by the bankrupt was applied. The court held:

> By the law of Arizona (where the land is situated), as stated in Baker v. Fleming, 6 Ariz. 418, there is no implied lien for unpaid purchase money. In other words, the creature of equity, known as a vendor's equitable lien, which is based upon the fact that the purchaser has not paid for what he has received, does not exist in Arizona and is regarded as contrary to the policy of that state. * * *
>
> We must give due effect to the decision in Baker v. Fleming, and this precludes us from raising upon equitable principles a charge for which the parties have not contracted. (p. 824.)

And so in *Minah Mining Co. v. Briscoe,* 89 Fed. 891, this court held:

> Such a lien is never created by contract. Equity creates and enforces one in proper cases, and, when recognized in the state in which is situated the property in respect to which it is asserted, the federal courts will recognize and enforce it. (p. 895.)

And coming nearer to the facts at bar, in *Perin v. Megibben,* 53 Fed. 86 (C. C. A., 6th Circ.), it was held:

> If the court of appeals of Kentucky have clearly laid down in their decisions a principle affecting the devolution of the equitable title to partnership real estate upon the death of one partner, it is a rule of property which the federal courts will respect and follow, instead of exercising their independent judgment, as they do with reference to questions involving the general common law of the state. (p. 92.)

The same principle is, under the precedents above cited, applicable in the case of personal property of a partnership. The *Perin* case is thus direct authority in the case at bar.

These authorities compel this conclusion: since the California court has determined that the partner's lien upon the assets of the firm subsists after dissolution and a subsequent statute has confirmed the lien without restricting its duration to the period of existence in fact of the partnership, a rule concerning the title to property has been established which the federal courts should not overthrow. Upon principle, is not this conclusion a just and proper one? Rapple and Lennig drew their contract of dissolution shaping their respective rights in the firm assets in contemplation of the law as adjudicated in this state. Under that contract, Rapple was entitled to believe that his lien was not destroyed. Must he apprehend that a court will apply to it the laws of other jurisdictions that a covenant "to apply the assets to the payment of the debts" is necessary to the desired result? If the controversy had arisen in the state courts, Rapple's property rights would have been protected. Should his rights be lost because the asset came into the custody of the bankruptcy court? The authorities say not. The record shows that the asset here was in the hands of the Fidelity & Guaranty Company before it was turned over to the trustee. Rapple could have sued the Guaranty Company in the state court and had that tribunal determine his rights. In liti-

gating his lien in the federal court, must he lose it because the courts of *other states* have held that such an agreement as he signed fails to preserve it? It is respectfully submitted that this as well as the first issue decided by this court should be reconsidered.

Dated, San Francisco,

October 25, 1915.

CAMPBELL, WEAVER, SHELTON & LEVY,
Attorneys for Appellant and Petitioner.

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for appellant and petitioner in the above entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact and that said petition is not interposed for delay.

DAVID L. LEVY,
Of Counsel for Appellant and Petitioner.